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Minerals Management Service
Royalty Management Program
Building 85, Denver Federal Center
Denver, CO 80225

Attention: Mr. David S. Guzy - Chief, Rules and Publications Staff

**Re: Notice of Reopening the Public Comment Period Concerning the Proposed Rulemaking for Establishing Oil Value for Royalty Due on Federal Leases, 30 C.F.R. Part 206, 62 Fed. Reg. 49460 (September 22, 1997)**

Dear Mr. Guzy:

Conoco Inc. ("Conoco") welcomes this opportunity to submit the enclosed comments to the Minerals Management Service ("MMS") with respect to the above-referenced Notice.

Conoco is a wholly-owned subsidiary of E. I. DuPont de Nemours and Company. In 1996 its worldwide production of crude oil, condensate, and natural gas liquids averaged 378,000 barrels per day and its worldwide natural gas production averaged 1,285 million cubic feet per day. During the five-year period ending December 31, 1996, Conoco remitted royalty payments to the MMS in excess of $393 million.

Conoco further adopts by reference and hereby incorporates the comments filed on behalf of the American Petroleum Institute and the Independent Petroleum Association of America.

Thank you for the opportunity to comment on this matter. If you have any questions, please contact Mr. John Clark at (405) 767-5044.

Very truly yours,

G C Rule

George C. Rule

Enclosure

cc: John Clark, Ponca City
Carol Harvey, Houston

## <u>Conoco's Comments Regarding MMS September 22, 1997 Federal Register Notice</u>

The Minerals Management Service ("MMS") has asked interested parties to comment on possible alternatives to the original proposed oil valuation rulemaking methodology noticed by the MMS in the Federal Register on January 24, 1997. These alternatives were noticed in the Federal Register on September 22, 1997. Additionally, certain groups were invited to participate in MMS scheduled and orchestrated workshops to discuss the possible alternatives. These workshops were held at MMS offices in Lakewood, Colorado and Houston, Texas. Conoco Inc. ("Conoco") appreciates that it had the opportunity to provide input at these meetings through its membership in COPAS. However, Conoco is of the opinion that the MMS has not allowed sufficient time to examine thoroughly these alternatives by the many groups who may be impacted by them if they are eventually implemented. The question of oil valuation is too significant for all concerned to attempt to craft a truly workable valuation methodology in a few short weeks. Conoco's following comments are intended to be additive to comments already submitted by it to the MMS on May 27, 1997 and August 1, 1997. As requested by the MMS, Conoco has focused these comments on the alternatives proffered by the MMS in the September 22, 1997 Federal Register.

***Valuation Benchmarks***

### <u>Alternative 1 - Tendering or Bid Out Programs</u>

Conoco offered a competitive bid program as an alternative during the public meeting in Houston, Texas on April 17, 1997. (Please refer to public comments by John Haley.) Conoco also had the opportunity to explain further and to respond to specific comments of the MMS, States, producer associations and others at both workshops held September 30 - October 1, 1997 in Lakewood, Colorado and on October 7-8, 1997 in Houston, Texas. Conoco strongly believes that competitive bid programs evidence market value at or near the lease, which is the stated objective of the MMS in proposing revisions to the oil valuation requirements for Federal Royalty Oil.

However, no competitive bid program will be the answer for every situation. The MMS must realize and accept that for certain leases or areas other alternatives will need to be implemented. Conoco suggests that competitive bid programs be a <u>choice</u> that lessees can make among other alternatives but also allow the lessees to use a different alternative where a competitive bid program is deemed to be unworkable. Conoco suggests that lessees work in partnership with the MMS to obtain MMS approval of a company's competitive bid program, which would not be unreasonably withheld, at the outset of a company's program so that the MMS is comfortable that the program is meeting MMS's objectives and also to ensure that both the MMS and lessees have common ground for auditing the results of the program. Conoco stands ready to review its current program, in detail, with the MMS at the convenience of the MMS.

As part of any new rulemaking, the MMS needs to continue to allow exceptions to any rule it imposes regarding oil valuation. Lessees need to have the ability to offer alternatives to value Federal Royalty Oil that may be unique to a specific situation. Conoco has certainly found that no one method works for every situation. One size does not fit all when it comes to oil valuation.

Conoco does not recommend that every lessee be required to use a competitive bid program. For some it would be too expensive. For others it would require a level of marketing expertise they may not possess. Rather, Conoco suggests that the MMS include a competitive bid program as a choice among MMS approved alternatives.

**Alternative 2 - Benchmarks**

Conoco strongly supports that lessees have a choice in valuing Federal Royalty Oil. Not every lessee is in the same economic position. Some do not have any marketing expertise while others have highly trained marketing staffs. Thus, both should not be required to use the same method to value lease crude.

Assuming that the MMS does not implement a RIK program for all Federal Royalty Oil, which is Conoco's first suggested alternative to the MMS, then the following choices are offered and should apply to every lessee, large or small. The lessee could choose one valuation method over another for each lease being valued for federal royalty purposes but would need to get MMS approval to make a switch from one method to another for any given lease. To be clear, at any one time a lessee may be using all of the following methods to value different leases due to varying circumstances which may be lease specific.

1. Gross proceeds for arm's-length sales at the lease or near the lease netted back to the lease. (Lessee would be responsible for validation that sales were arm's-length sales.)

2. Competitive Bid Program (pre-approved by the MMS). Explained with respect to Alternative 1 above.

3. Comparable arm's-length sales. (Once again, this would be pre-approved by the MMS and definition of terms of like kind and quality, field, or area would be part of the pre-approval process by the MMS.)

4. Netback from a Market Center. Conoco is opposed to this method and any requirement that it collect and provide information to the MMS as was suggested in the January 24, 1997 notice of proposed rulemaking through the use of the proposed MMS-4415 form.

The choices should not be in any order but rather be a "menu" for an election by the lessee. A lessee would elect one of the methods above, which may be lease specific, and thereafter maintain that election for valuation purposes unless and until the lessee wishes to elect another benchmark.

The MMS should not retain language that would suggest that the MMS be paid on the "higher of gross proceeds or benchmark value". Conoco is concerned that the MMS could "game" the lessee by first accepting an elected benchmark and then at some later time construct an inappropriate "gross proceeds" value based on conjecture and presumptions that are not applicable or factual to a lease in question. If the MMS has accepted an election, then the lessee should have certainty that this election will stand until either the MMS or the lessee chooses to change the election on a prospective basis.

To establish an arm's-length value, Conoco is advised by The Economic Resources Group, Inc., Cambridge, MA that placing approximately 10% of lease volume in a designated area in the arms-length market should fairly approximate fair market value. However, each situation is unique and the MMS may want to review the elected benchmarks of the lessees to assure themselves that arms-length sales are reasonable and thus may serve as a proxy lease value for valuing Federal Royalty Oil.

Validation that Conoco's sales under its competitive bid program are indeed "arm's-length" may be ascertained from its contract documents. First, Conoco states to prospective bidders in its solicitation for bids transmittal letter that "Conoco warrants that the sale of these barrels will be outright sales. The purchaser is under no obligation, expressed or implied, to exchange, sell or in any way pay back barrels to Conoco as a condition of this sale." Additionally, in the actual sales contract with the winning bidder Conoco states under the heading "Balancing" that "Seller warrants that the barrels sold herein are an outright sale to buyer. Buyer is under no obligation, expressed or implied, to exchange, sell, or in any way pay back barrels to seller as a condition of this sale." To the extent that the MMS thinks that Conoco has some form of "overall balancing agreement(s)" with companies with whom it has buy/sell contracts, the MMS has unfortunately been misled. If others in the industry have such agreements, Conoco is unaware of them.

**Alternative 3 - State Indexing Proposal**

The MMS has asked for comments regarding a proposal by one state that the MMS establish value based on geographic indexing using its (i.e. MMS's) own system data. The State goes on to propose that the MMS insure that "posted prices are not included when using the system data to determine market prices....".

The MMS apparently does not have data in its possession that this State thinks it has. If they did, the matter would be simplified. However, under this proposal the MMS would be faced with the daunting task of setting the value of crude oil by geographic areas. This proposal is fatally flawed for at least two reasons. "One size does not fit all" when it comes to crude valuation and lessees would be required to do double accounting. They would be required to initially pay the MMS on their best guess of value based on whatever they thought the MMS index would be for their lease and then they would have to recalculate and make adjustments based on the actual index published by MMS at some time in the future. This alternative is a "lose/lose" situation for both the MMS and the lessee and should be rejected as not reflecting true market value at the lease and also as being too burdensome for both the MMS and the lessee.

Regarding the issue of different methods for valuing Federal Royalty Oil for different areas, Conoco supports such a concept. Crude oil markets on the West Coast are totally different from crude oil markets East of the Rockies and thus should be valued differently if that is required to determine lease value. Likewise, certain markets East of the Rockies are different from each other. Crude market value in the Rockies are determined by influences and factors different than markets in West Texas or South Texas. Thus, a generic approach will not be representative of lease market value in every area. As stated above, Conoco supports a rulemaking that would allow the lessee to be able to elect how it chooses to value Federal Royalty Oil, which would be approved, in advance, by the MMS. Such approval would not be unreasonably withheld.

**Alternative 4 - Fixed Differential Netback**

Conoco is concerned that this suggested alternative would not represent market value at the lease. Once again, its basic premise is that "one size fits all." This alternative is much simpler than indexing or the MMS's originally proposed rulemaking and would be much easier to audit, which are perhaps its only good points. However, it would be problematic for some smaller lessees who might have difficulty in actually obtaining the MMS imposed "standard" lease value such a system assumes is available to every lessee. If a lessee is not able to obtain such a lease value, then such lessee would be forced to pay the MMS "out-of-pocket," which the MMS should find repugnant and in violation of the principle of fairness.

As more fully explained under Alternative 5, Conoco remains opposed to any scheme that uses a figure netted back from a trading center to represent or generate value at the lease. Therefore, any such trade center netback scheme should not be mandated but rather be included as a choice for other lessees who may be willing to accept these market deficiencies.

**Alternative 5 - Platt's vs. NYMEX Netback**

Again the MMS is requesting comments on an alternative suggested by one State that replaces NYMEX with Platt's Oilgram ("Platt's") reported spot pricing. It was made clear at the workshops that there is little or no difference between Platt's or NYMEX over time. Hence, the real flaws of the NYMEX netback methodology proposed by the MMS in its January 24, 1997 Notice of Proposed Rulemaking have not been corrected. Quite simply, any such system does not reflect value at the lease. Conoco has already commented on this issue in the first two rounds of comments and will not repeat itself here. However, any attempt to substitute Platt's spot pricing for NYMEX to correct the deficiencies of the original MMS proposed rulemaking misses the mark. The reality is that there is no lease market at Cushing, Oklahoma, nor St. James, Louisiana, nor Guernsey, Wyoming. These markets are made up of buyers and sellers with different economic incentives and agendas than those who make up markets at the lease. Indeed, Conoco is a major lease crude buyer because we have a significant shortage of crude to meet our refinery needs. Nevertheless, Conoco does not participate in all lease markets. Conoco has to concentrate its efforts where it has an economic need and perceived competitive leverage. Additionally, Conoco has a different set of competitors at the lease level versus trade center markets. The "players" that make up the market at the lease are diverse and differ lease-by-lease and each will likely have a different economic agenda than they would have trading in the NYMEX or in the cash market. These two markets are not the same.

Any such trade center netback scheme should not be mandated but rather included as a choice for any lessee who is willing to accept these market deficiencies.

***Duty to Market***

Conoco strongly disagrees with MMS' assertion that the lessee has a duty to market on behalf of the MMS free of charge. If we have a duty to market, does the MMS have the right to dictate which market we have to market in? Please refer to our previous comments on this issue submitted on May 27, 1997.